

**Letter of Findings Number: 10-0407**  
**Sales and Use Tax**  
**For Tax Years 2007-09**

**NOTICE:** Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUE**

**I. Sales and Use Tax—Manufacturing Exemption.**

**Authority:** General Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); North Central Industries, Inc. v. Indiana Dep't of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-14](#); [45 IAC 2.2-5-16](#); [45 IAC 2.2-3-4](#).

Taxpayer protests the imposition of use tax on several items.

**STATEMENT OF FACTS**

Taxpayer is an Indiana manufacturer. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had purchased tangible personal property during the tax years 2007, 2008, and 2009, but had not paid sales tax on some of the items. The Department therefore issued proposed assessments for use tax and interest for those years. Taxpayer protests that some of the items which the Department included as taxable were actually eligible for the manufacturing exemption and were therefore exempt from sales and use tax. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

**I. Sales and Use Tax—Manufacturing Exemption.**

**DISCUSSION**

Taxpayer protests the imposition of use tax on several items which it believes are eligible for the manufacturing exemption. The Department selected a sample of Taxpayer's purchases and projected the resulting error/compliance rate to the entire three-year audit period. The Department imposed use tax on the items after determining that the items constituted pre-production equipment, post-production equipment, or capital assets, none of which qualify for the manufacturing exemption. Taxpayer protests that some of the items included as taxable in the projection method are used in its manufacturing process and are therefore exempt from sales and use tax. Taxpayer therefore believes that those items should be removed from the category of taxable items in the projection method and the error/compliance rate recalculated and reapplied to the audit period. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The sales tax is imposed by IC § 6-2.5-2-1, which states:

- (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
- (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

- (a) An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

Also, [45 IAC 2.2-3-4](#) provides:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is acquired in a retail transaction and is stored, used, or consumed in Indiana, Indiana use tax is due if sales tax has not been paid at the point of purchase. In this case, the Department determined that Taxpayer had acquired tangible personal property in retail transactions and used that property in Indiana without paying sales tax at the point of purchase. The Department therefore issued proposed assessments for use tax, as provided by [45 IAC 2.2-3-4](#).

Taxpayer protests that the items under protest qualify for the manufacturing exemption. This exemption is found at IC § 6-2.5-5-3, which states:

- (a) For purposes of this section:
  - (1) the retreading of tires shall be treated as the processing of tangible personal property; and
  - (2) commercial printing shall be treated as the production and manufacture of tangible personal property.
- (b) Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct

use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.  
(Emphasis added).

As provided under IC § 6-2.5-5-3(b), items must meet the "double direct" test in order to qualify for exemption.

The Indiana Tax Court has addressed the question of what constitutes a manufacturing operation. In *General Motors Corp. v. Indiana Dep't of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991), the Court provided:

The double direct standard, expressed in the statutory language emphasized above, is the touchstone of the equipment exemption from sales/use tax. In *Indiana Department of State Revenue v. Cave Stone, Inc.* (1983), Inc., 457 N.E.2d 520, the seminal case interpreting the double direct standard, the Indiana Supreme Court recognized the essential and integral test to determine whether the double direct standard is met. The court held the transportation equipment at issue was both essential to transforming crude stone into a marketable product and integral to "the ongoing process of transformation." *Id.* at 524.

The court's inquiry focused on the production process itself, defining it broadly to encompass all the production steps involved in transforming work in process into a finished marketable product:

The [equipment exemption] statute circumscribes all of the operations or processes by which the finished product is derived. **Thus, we find that the production or processing of the stone begins at the time of the initial stripping, drilling, and blasting at the quarry and ends at the time the stone is stockpiled. The production process is continuous and indivisible.**

(Emphasis added).

The Court further provided:

The Department erroneously draws an artificial and arbitrary boundary based on the first marketable product to emerge rather than drawing the more logical line based on the actual end product produced. Under an approach focusing on the actual end product marketed, GM's packing materials used to transport component parts sold to non-GM manufacturers and those used to transport finished replacement parts would still be taxed. On the other hand, packing materials used to transport work in process parts from GM's component plants to GM's assembly plants would be exempt as an essential and integral part of GM's integrated production process of manufacturing finished automobiles. **Finally, a determination that an integrated production process ends upon the completion of the actual end product marketed (the most marketable product) is wholly consistent with the legislative purposes of the exemption statutes to encourage industrial growth and to avoid tax pyramiding.**

*Id.* at 405.

(Emphasis added).

In that case, General Motors had several component plants which made components which were assembled at another General Motors plant. The Court determined that General Motors' integrated production process began at the various General Motors component plants and ended upon the completion of the actual end product marketed, which in General Motors' case was a finished vehicle, at another General Motors plant. Taxpayer believes that its production process begins at the point it begins moving rolls of raw materials to the production staging area.

Taxpayer is incorrect. The Indiana Tax Court explained in *North Cent. Industries, Inc. v. Indiana Dep't of State Revenue*, 790 N.E.2d 198, 200 (Ind. Tax Ct. 2003):

To qualify for the equipment exemption, North Central must show, in part, that it is engaged in the direct production or manufacture of other tangible personal property. See *Gen. Motors Corp. v. Indiana Dep't of State Revenue*, 578 N.E. 2d 399, 401 (Ind. Tax Ct. 1991), *aff'd*. **If it satisfies this element, North Central must then show that the equipment for which it seeks an exemption is directly used in the production of the tangible personal property.** See *id.*

Although "[t]here are innumerable ways to produce other tangible personal property, [Indiana Code Section 6-2.5-5-3] cannot be expected to give a precise answer to each factual situation that arises." *Rotation Prod.*, 690 N.E.2d at 798. **Nevertheless, the Department's rules make clear that production must entail a "substantial" change or transformation that "places tangible personal property in a form, composition, or character different from that in which it was acquired."** IND. ADMIN. CODE tit. 45, r. 2.2-5-8(k) (2001). Moreover, production must increase the number of "scarce economic goods," i.e., it must create a new, marketable product. *Harlan Sprague Dawley, Inc. v. Indiana Dep't of State Revenue*, 605 N.E.2d 1222, 1226 (Ind. Tax Ct. 1992) (quoting *Borden Co. v. Borella*, 325 U.S. 679, 65 S.Ct. 1223, 89 L.Ed. 1865 (1945)).

(Emphasis added).

Therefore, equipment directly used in the direct production of Taxpayer's product is eligible for the manufacturing exemption. Equipment used prior to the start of the production process or after the end of the production process is not eligible for the manufacturing exemption.

In the audit report, the Department determined that Taxpayer's production process began after the placement of raw material on the production machinery and ended with the manufacture of Taxpayer's product as marketed.

[45 IAC 2.2-5-8](#) provides in relevant parts:

(a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

(b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.

(c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

—EXAMPLES—

(1) Aluminum pistons are produced in a manufacturing process that begins, after the removal of raw aluminum from storage inside the plant, with the melting of the raw aluminum and the production of castings in the foundry; continues with the machining of the casting and the plating and surface treatment of the piston; and ends prior to the transportation of the completed pistons to a storage area for subsequent shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process, comprised of such activities, is integrated.

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.

...

(G) An automated scale process which measures quantities of raw aluminum for use in the next production step of the casting process in the foundry.

...

(4) Because of the lack of an essential and integral relationship with the integrated production system in Example (1), the following types of equipment are not exempt:

...

(G) Equipment used to remove raw materials from storage prior to introduction into the production process or to move finished products from the last step of production.

...

(g) "Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

—EXAMPLES—

(1) The manufacturing equipment utilized for the production of plastics consists of an interconnected system which contains among its components a coal fueled boiler, heat exchangers, vacuum jets, process heating vessels, distillation/stripping columns, related equipment, and piping. All elements of this integrated production process are exempt from tax.

...

(j) Managerial, sales, and other non-operational activities. Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading.

(k) "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition,

or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

....

(Emphasis added).

Taxpayer believes that the items under protest are all parts of an integrated process and are therefore exempt from sales and use tax under this regulation.

The first group of items under protest includes poly ink rolls and a type wheel assembly. Taxpayer refers to [45 IAC 2.2-5-8\(c\)](#) example (2)(G) in support of its protest. Taxpayer believes that the poly ink rolls and type wheel assembly serve the same function as the aluminum-measuring equipment discussed in the example, and that the manufacturing process includes tracking of materials used in the manufacturing process.

The Department does not agree with this conclusion. The poly ink rolls and type wheel assembly help Taxpayer track the materials, but do not become an integrated part of Taxpayer's product. Unlike the aluminum-measuring equipment described in [45 IAC 2.2-5-8\(c\)](#) example (2)(G), the poly ink rolls and type wheel assembly do not measure out pieces to be integrated into the end product.

The next items under protest are inventory scanners. Taxpayer believes that these items should be exempt since they perform their functions during the production process and allow Taxpayer to track its product grade and quantity. As described above, any item must be directly used in the direct production of a taxpayer's product in order to qualify for the exemption. Here, the inventory scanners help Taxpayer track items. They have no direct effect upon the product and are not directly used in the direct production of Taxpayer's product.

The next items under protest are thermal transfer labels for inventory. Taxpayer states that these labels are necessary for inventory identification purposes during production. The labels list the size and grade of raw materials. Taxpayer believes that the functional interrelationship of the various steps and the flow of the work-in-progress makes the maintenance of such information an integrated part of the production process. Similarly, Taxpayer claims that toner/ink cartridges for work-in-process measurement labels are exempt. Taxpayer points out that these labels are printed directly on the product and are printed prior to strapping.

Taxpayer is incorrect. As described above, the manufacturing exemption requires direct use in the direct production process in order for an item to qualify for the exemption. Here, the thermal transfer labels, however necessary for Taxpayer's tracking purposes, do not meet that standard. Neither do the toner/ink cartridges qualify for the exemption since they also do not meet that standard. Those labels are also for tracking purposes, not for the purposes of becoming an integrated part of Taxpayer's product. [45 IAC 2.2-5-14](#) provides:

- (a) The state gross retail tax shall not apply to sales of any tangible personal property which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale by such purchaser in the business of manufacturing, assembling, refining or processing.
- (b) The exemption provided by this regulation [\[45 IAC 2.2\]](#) applies only to tangible personal property to be incorporated as a material or an integral part into tangible personal property produced for sale by a purchaser engaged in the business of manufacturing, assembling, refining or processing. This regulation [\[45 IAC 2.2\]](#) does not apply to persons engaged in producing tangible personal property for their own use.
- (c) This regulation [\[45 IAC 2.2\]](#) does not exempt from tax tangible personal property to be used in production, such as supplies, parts, fuel, machinery, etc., refer to Regs. 6-2.5-5-5(010) and 6-2.5-5-5(020) (dealing with material consumed in direct production) for the application of those regulations to taxpayers engaged in the production of tangible personal property.
- (d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. "Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:
  - (1) That the material must be physically incorporated into and become a component of the finished product;
  - (2) The material must constitute a material or an integral part of the finished product; and
  - (3) The tangible personal property must be produced for sale by the purchaser.
- (e) Application of general rule.
  - (1) Incorporation into the finished product. The material must be physically incorporated into and become a component part of the finished product.
  - (2) Integral or material part. The material must constitute a material or integral part of the finished product.
  - (3) The finished product must be produced for sale by the purchaser.

(Emphasis added.)

The fact that they are printed on the product and prior to the strapping of the product for shipping is not determinative. The production process has ended by the time these labels are printed. The strapping stage is not part of the production process. While the strapping materials themselves are separately exempt, as provided by [45 IAC 2.2-5-16](#), the strapping and packaging process is not in itself an exempt process and it is not part of the production process. Therefore, the labels in question do not constitute a material or integral part of the finished product, as required by [45 IAC 2.2-5-14\(f\)\(2\)](#), and are not part of the production process.

The next group of items under protest is clamp trucks and clamp truck repair parts, which Taxpayer states are used seventy-five (75) percent of the time in an exempt manner. Taxpayer explains that the clamp trucks move materials from the loading docks to the production area, in between stages in the production process, and from the packaging station to the outgoing truck beds for delivery. Taxpayer provided calculations to explain how it arrived at the 75 percent exemption rate it suggests.

After review of these calculations, the Department concludes that Taxpayer is mistaken. The trucks do not move Taxpayer's product. Rather, they move rolls of raw materials either to or from the loading docks or from production machine to production machine. The clamp trucks do not move the work-in-process, meaning Taxpayer's product, and are not part of the production process.

The next items under protest are items which Taxpayer believes qualify for the safety equipment exemption. This exemption is found at [45 IAC 2.2-5-8\(c\)](#), which provides in relevant part:

-EXAMPLES-

...

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.

...

**(F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production. (Emphasis added).**

....

One group of items under protest is dock locks, which secure truck trailers to the loading dock. Taxpayer believes that the dock locks allow its employees to participate in the production process without injury by preventing movement of the truck trailers.

The Department does not agree with this conclusion. As provided by [45 IAC 2.2-5-8\(c\)](#) example (2)(F), the equipment must allow a worker to participate in the production process without injury. The dock locks are used on the loading dock, either before or after the production process has taken place. Therefore, even if the locks do prevent injury, they are not required to allow workers to participate in the production process and do not qualify for the exemption found at [45 IAC 2.2-5-8\(c\)](#) example (2)(F).

Taxpayer argues that another category of equipment qualifies for the safety equipment exemption. Taxpayer's production process is very loud and Taxpayer believes that communication equipment is necessary for its workers to participate in the production process without injury. In this case, Taxpayer is correct. The communications equipment, used in conjunction with hearing protection equipment allows the workers to be on the production line and to participate in the production process without suffering hearing loss. As established by the documentation provided as part of the protest process, the communication equipment is part of the hearing protection system. This qualifies for the exemption found at [45 IAC 2.2-5-8\(c\)](#) example (2)(F).

The next protest category is boom rentals. Taxpayer states that it rents booms to either repair or provide maintenance to its production equipment. The booms also assist in changing the settings on the production equipment. As provided above, the booms are not directly used in the production process and are therefore not eligible for the manufacturing exemption. As provided by [45 IAC 2.2-5-8\(h\)](#):

(1 ) Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

(2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.

-EXAMPLE-

A manufacturer of sheet metal repairs and upgrades used machinery by replacing worn or broken parts and adding new elements and features available in state-of-the-art equipment. All items which become components of the upgraded machinery are exempt from tax. However, all tools and equipment used to repair or upgrade used machinery would be taxable. (Emphasis added).

The booms are used to repair or upgrade the production machinery and, as provided by the example above, are taxable.

The final category under protest is computer terminals which Taxpayer's employees use to sequence its inventory of rolls of raw material for production. As previously explained, such equipment does not have a direct effect on the items being produced. Therefore, the sequencing scanners do not qualify for the manufacturing exemption.

In conclusion, equipment must be directly used in the direct production process in order to qualify for the manufacturing exemption. None of the categories of equipment under protest qualify for that exemption since they are not directly used in the direct production of Taxpayer's product. Of the two categories for which Taxpayer claims the safety equipment exemption, only the communication gear which is used in conjunction with the hearing protection equipment qualifies for this exemption. Therefore, the Department will conduct a supplemental

audit which will remove the communication equipment from the sample and projection calculations and will recalculate the error/compliance rate. The Department will then apply the new rate to the tax years at issue, and will issue bills reflecting the reduced amounts of use tax due.

**FINDING**

Taxpayer's protest is sustained regarding the safety/communications equipment. Taxpayer's protest is denied regarding all other protested items.

*Posted: 02/23/2011 by Legislative Services Agency*

An [html](#) version of this document.